Free trade negotiations
between Mexico, Canada
and the United STates

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FREE TRADE NEGOTIATIONS BETWEEN MEXICO, CANADA AND THE UNITED STATES: BACKGROUND AND ISSUES

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Economics Division

September 1990

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FREE TRADE NEGOTIATIONS BETWEEN MEXICO, CANADA AND THE UNITED STATES: BACKGROUND AND ISSUES

INTRODUCTION

The United States and Mexico appear ready to negotiate a free trade deal. Canada has decided it wants to join them and broaden the discussion to include a North American free trade arrangement. Obviously, this is an important issue and one that may have far-reaching effects on the structure of Canadian industry.

Because Canada has recently negotiated its own deal with the U.S., much of the general background to such a trade arrangement is familiar to Canadians. Accordingly, this paper focuses on Mexico and free trade, providing background on the Mexican economy and highlighting, from a Canadian perspective, the issues raised by a possible Mexican-Canadian-U.S. free trade area. (Table 1 provides a statistical profile of Mexican trade patterns.)

BACKGROUND

Mexico is a developing country with low per capita GNP and high, even staggering, levels of external debt. It borders the United States, and that fact alone is responsible for much of Mexico's political and economic policies.

This section highlights some of the important economic facts about Mexico; fuller studies of the country's economics and politics may be found elsewhere.(1)

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(1) P. Dulude and G. Schmitz, "Mexico," Background Study, Library of Parliament, 16 December 1982, revised 10 April 1990. This paper includes other references.

The following table, based on data from a recent study by the Royal Bank, compares the United States, Canada and Mexico.

	United States	Canada	Mexico
Population (millions)	248.8	26.3	85.0
GNP* (U.S. $ billions)	5,200.8	531.6	201.4
GNP* per capita (U.S. $)	20,904	20,214	2,365
Inflation rate (%)	4.8	5.0	20.0

* GDP for Mexico.

Source: Royal Bank of Canada, "Mexico-U.S. Free Trade Talks: Why Canada Should Get Involved," (Special Issue of Econoscope), September 1990.

Several observers have noted that the total for the three populations (360 million) and the total for their GNP or GDP (almost US$6 trillion) are about the same as those of Europe -- an area that will become an even more important economic power and trade bloc in 1992. Such arithmetic, with its emphasis on totals for North America and Europe, ignores the great disparity between Mexico and its northern neighbours.

Of the three nations in a possible North American Free Trade Area (hereafter, NAFTA), Mexico is much the poorest. By way of comparison, Canada's per capita GNP is eight and a half times that of Mexico. The disparity between the U.S. and Mexican per capita GNP is slightly wider. It is the U.S.-Mexican gap that has led to large flows of illegal immigration to the U.S.; some see a U.S.-Mexico free trade deal as a partial solution to that problem.

Per capita comparisons at a single given moment, however, can be misleading. In the 1980s, for example, Mexico's population grew at a rate twice that of Canada, so even if production in the two countries had grown at the same rate, the gap between their per capita GNPs would have widened over the decade. In fact, economic growth in Mexico did not keep pace with that in Canada or the U.S. during the eighties.

Mexico's problems in the past decade reflect, in part, the squandered opportunities of the seventies. This paper is too short to attempt an economic history of the two decades, however; it is probably more useful and efficient to take several important characteristics of the

current Mexican economy and show how these evolved from Mexico's past and will influence its future.

Mexico is a developing country struggling with both potential and problems. Its most important economic characteristics are:

- low wages;
- high debt;
- oil resources;
- structural problems;
- attempts at economic liberalization; and
- maquiladora (free trade or export area).

These characteristics, which are, of course, related, will be discussed below. (A statistical profile of Mexico's trade is given at the end of this paper.)

A. Low Wages

One U.S. analyst put the average hourly wage in the Mexican manufacturing sector at $1.90 (with the U.S. and Canadian wages at $14.50 and $13.88, respectively). Shirley Carr of the Canadian Labour Congress has suggested that the average Mexican wage is $0.60 to $1.20. A recent Canadian Senate report put the average wage for assembly work at $0.60, but pointed out that variations in the costs of transportation and meals made the calculation difficult. An article in Maclean's magazine examined wages in the auto parts manufacturing sector, and reported that "Mexican workers currently earn about $1.60 to $2 an hour, compared with the $20 hourly wages paid their Canadian counterparts."

Whatever the precise figure for Mexican wages, the statement that Canadian workers' earnings are approximately ten times those of Mexican workers is close enough to the truth; this explains why Canadian and U.S. workers fear that free trade with Mexico would lead to their countries being swamped by goods made in Mexico. Surprisingly, however, it is Mexico that has had the highest barriers to trade with the rest of North America. The reason for this apparent anomaly is that productivity is very low in Mexico, a problem aggravated by past policies of protection and import substitution that have also entrenched inefficiencies.

A further consideration is that estimates of relative wages should include differences in the cost of living. Costs are lower for many basics in Mexico, but not enough to offset the much lower effective wages there. Moreover, effective wages in the U.S. and Canada include many fringe benefits that further increase the discrepancy between total real wages in those countries and those in Mexico.

Mexico's rapid population growth mentioned above means that there will be downward pressure on wages, or, if wages are sticky, increases in unemployment. With 750,000 to 1 million workers or would-be workers entering the labour force each year, the Mexican government will face political problems if it cannot produce jobs.

B. High Debt

While the Mexican government searches for a way to promote job-creation, it must still cope with daunting problems of debt. Understandably, it is Mexico's external debt that has attracted the most attention and which, at about US$100 billion, makes Mexico the developing world's second biggest debtor behind Brazil. (Of the US$101.6 billion stock of debt in 1988, US$63.4 billion was owed to commercial banks. At the beginning of 1990, Canadian banks were owed about $5 billion.) In August 1982, Mexico precipitated the so-called international debt crisis by announcing that it could not service its debt and declaring a moratorium on debt repayments.

The declaration proved a strong incentive to private banks and official institutions to tackle the debt problem. At first there were ad hoc re-schedulings by the banks and then various plans were put forward by governments and official organizations. The Brady Plan, suggested in March 1989 by the U.S. Treasury Secretary, stretched out the debt burden for Mexico. Although this provided important temporary relief, it did not eliminate the problem.

There are several causes of Mexico's huge debt. High real interest rates and the collapse of world oil prices in the eighties are two of them. These causes are outside the control of Mexico. Many observers,

however, see these external factors as aggravating a fundamental problem, namely fiscal mismanagement of the domestic Mexican economy since the early 1970s. According to the Economist magazine, "the country's debt crisis was mainly home-grown," the result of reckless public spending, an overvalued exchange rate and excess protection for industry.

The motives for the expansionist policies of Presidents Echeverria (1970-76) and Lopez Portillo (1976-82) were in part very noble -- to maintain the standard of living for Mexicans and tackle the related problems of poverty and an extremely skewed distribution of income and wealth. But good intentions are never enough. The policies led to a massive increase in public spending, from 32% of GDP in 1978 to 48% in 1982, and eventually to triple-digit inflation. The public sector borrowing requirement rose with government spending, from 7% of GDP in 1978 to 17% in 1982. (For comparison, Canada's public sector borrowing requirement was about 6% of GDP in both 1978 and 1982.)

C. Oil Resources

That Mexico struggles with both potential and problems may be explained by one word: oil. That country has long produced oil, but in the mid-seventies, when OPEC was forcing prices up, Mexico discovered the rich new reserves that have turned it into the world's fourth largest oil producer. Oil seemed to provide the money to afford expansionist fiscal policies. In fact, oil revenues did rise, nearly nine-fold between 1978 and 1982, but public spending rose more.

And then oil prices fell. In a 1987 survey of Mexico, the Economist magazine highlighted the problem:

> The "mix" of Mexico's Maya and Isthmus oils sold for $26.70 a barrel in February 1985; a year later the price had collapsed to $14.30, declining still further to $8.60 by July 1986. Looked at another way, whereas contributions from Pemex [Mexico's state-owned oil monopoly] had accounted for more than a third of the government's revenues in 1984 and 1985, in 1986 they fell to about a quarter.

Rising oil revenues before the price collapse had masked poor economic management; Mexico was willing to borrow heavily to support

unnecessary investment and a spending binge, confident that future oil revenues would more than pay back the loans. There was also the problem of greed. As the Economist survey summed up the problem:

> Mr. Lopez Portillo and his cronies grabbed vast amounts of the oil revenue. So did the top officials in Pemex, the nationalized oil company. So did the corrupt, ruthless and venal oil workers' union. So did middlemen acting between the international banks and their Mexican clients. (Yet the greed was confined to a few; most officials are not corrupt, and few Mexicans are well placed to benefit from corruption.)

When the collapse came, it exposed -- and exposed quite painfully -- the poverty of the inward-looking economic policies being pursued. The mid-eighties' collapse of oil prices may thus prove to have been a blessing in disguise; it forced the Mexican government to make drastic structural changes to the economy.

The changes, to be discussed below, may be difficult to maintain. But, here again, oil may be an important factor. The recent mid-east crisis has put upward pressure on the price of oil, and, according to one estimate, every increase of $1 per barrel adds $500 million annually to Mexican revenues. With luck and sounder economic policies, Mexico may not again squander these benefits from its oil resources.

D. Structural Problems

Recognizing past policy mistakes is no guarantee that the policies will not be repeated. Even if these policies are rejected, however, problems will remain; the mistakes of the past are embedded in the system. Special interest groups that benefited from protection have the political clout to thwart attempts at liberalization; expectations of inflation or exchange depreciations are difficult to change after a period of high inflation and a series of sharp devaluations; capital that left the country (or foreign capital that stayed away) does not immediately return.

All these problems plague Mexico. Unions are still powerful and will remain so. Pemex, for example, continues to be heavily influenced by a union the Economist termed "corrupt, ruthless and venal." Many

observers consider Pemex to be a patently inefficient company, and it may, because of its position, power and symbolic importance, be sheltered from economic liberalization and a needed blast of competition.

Inflation remains a problem. President Salinas's policies have brought the inflation rate down from 114% per year in 1988 to 20% in 1989. The drop seems miraculous to some -- and it is certainly a good omen -- but it is still about four times the inflation rates in the U.S. and Canada. Rapid inflation can lead to exchange depreciation. During the period 1977 to 1980, when prices in Mexico were rising about 20% per year, the Mexican exchange rate was relatively flat; during the 1980s, as inflation accelerated to the triple-digit range, there were a series of sharp devaluations. One measure of the value of the peso went from 23.3 to U.S.$1 in 1980 to 2,281 to U.S.$1 in 1988.

The overvaluation of the peso in the late 1970s and the crumbling Mexican economy led to massive outflows of private capital. With recent attempts at economic liberalization, there has been a repatriation of some of this money. One estimate is that US$2.5-3.0 billion returned in 1989, although such estimates, like the estimates of the outflows, are not very precise. What is important is the potential structural problem of very mobile capital that will not tolerate real or apparent mistakes in economic behaviour, such as a return to past policies.

The traditional answer to economic problems in Mexico has been to blame foreign, especially U.S., control of the economy and to look inward. This populist approach has failed in the past but its emotional appeal is undeniable. With the slim majority enjoyed by the Salinas government, the threat of such a return to latent nationalism may pose the greatest structural problem.

E. Attempts at Economic Liberalization

In 1985, with oil prices falling, the results of poor economic policies visible and the country hard hit by an earthquake, Mexico applied for membership in GATT and unilaterally began lowering its trade

barriers. Tariffs were slashed; by 1987, a ceiling of 20% had been placed on all tariffs, and the trade-weighted average tariff is now about 6 to 8%.

President Salinas and his economic advisors believe in freer trade and the importance of competition. In May 1989, he unveiled a national development plan based on promoting foreign investment, liberalizing financial markets and further reducing tariff barriers.

Forbes magazine, in a recent article entitled "A Revolution You Can Invest In," praised the reforms taking place in Mexico and pinpointed 14 May 1990 as a turning point in economic policy. On that date, Mexico's Congress voted to privatize banking. The article listed several steps taken by the Salinas government to liberalize the economy:

1) reducing the top marginal tax rate to 35%, the latest in a series of gradual reductions, from 60% in 1986;

2) abolishing the special tax status of small companies, a first step toward integrating them into the mainstream economy, so they may grow and combine into larger enterprises;

3) abolishing similar special tax status for transportation and agricultural companies;

4) throwing out a huge number of offensive regulations, notably most restrictions on foreign investment, transportation regulations, protection of the state petrochemical monopoly and so forth;

5) eliminating most of the remaining non-tariff barriers to trade, including domestic-content quotas for autos and electronics; and

6) selling off the majority of state industrial holdings (the big exception is and will remain Pemex, the national oil company).

Promotion of a free trade deal with the United States is part, and an important part, of the policy of economic liberalization. But there are pitfalls and obstacles, not the least of which are special interest groups in Mexico and the U.S.

F. Maquiladora (Free Trade or Export Area)

The maquiladora area is a strip about 28 kilometres wide along the northern border of Mexico. The term translates roughly as "grist mill" but now is used as synonymous with "Mexican free trade zone" or "Mexican export zone." Foreign ownership is permitted in the area, and components are allowed duty free into the zone on condition that the final product is exported. Not surprisingly given the location, most of the components come from the U.S., which is also the destination of most of the assembled products.

Trade unions in the U.S. argue that the maquiladora program costs jobs in the U.S. and point to the wide disparity in wages in the two countries. There may be some truth in this, although with the globalization of production by large corporations, the jobs in Mexico may come at the expense of jobs in low-wage Asian countries. In addition to its low wages, the maquiladora area is attractive to U.S. firms because it shares time zones (Mountain and Central) with head offices and other plants in the U.S.

Whatever the reasons, the program has been successful. Since 1972, a plant set up almost anywhere in Mexico can take advantage of the terms of the maquiladora program, although most such plants are still in the original maquiladora zone. About 2,000 companies, mostly U.S. and Japanese, have set up plants under the program, and about 500,000 Mexicans are employed in them.

The major auto makers and affiliated parts plants have located in the area, and this raises concerns about possible effects of the maquiladora program on the Auto Pact between the United States and Canada. Major electronic manufacturers have also come to the area, so country-of-origin rules become important to prevent "Mexican" products from coming to Canada duty free under the Canada-U.S. Free Trade Agreement.

A U.S.-MEXICO FREE TRADE AGREEMENT

With or without the participation of Canada, the Administration in the U.S. seems intent on pursuing free trade with Mexico. Mexico

is the United States' third largest trading partner, after Canada and Japan, with trade flows totalling about US$45 billion.

Most of the general arguments for free trade are familiar to Canadians, who heard them when this country was negotiating its agreement with the U.S. They also hold for trade liberalization between the U.S. and Mexico. In fact, given the high barriers to trade that recently existed in Mexico (and still exist in some sectors such as energy), the potential gains from trade liberalization are quite large. (So, too, are the potential adjustment costs, an important political factor in determining whether trade will be liberalized and to what degree.)

The U.S. has long been concerned with Mexican treatment of intellectual property rights and, a related point, the protection afforded in Mexico to emerging hi-tech industries or established industries like the telephone industry that are now being transformed by technological advances. Obviously, trade liberalization would lower barriers against the goods and services for which the U.S. has a comparative advantage; Mexico would gain from increased choice and lower prices -- and from greater competition, which carries with it adjustment costs.

In addition to these standard arguments for free trade, the U.S. has several additional reasons for obtaining an agreement with Mexico: first, it might open up trade with other Latin American countries; second, a trade deal might increase cooperation in curbing the flow of drugs to the U.S; third, a trade deal might produce a healthier Mexican economy, one better able to service its large foreign debt. These three reasons can also be used to support freer trade between Canada and Mexico.

A fourth argument, unique to the United States, has to do with illegal immigration from Mexico, which has long been a problem in the U.S. border states. Because standards of living differ so markedly between the two countries, Mexicans are willing to risk heavy costs attempting to enter the U.S. If a trade agreement leads to higher employment and real incomes in Mexico, some potential illegal immigrants to the U.S. may decide to stay in Mexico.

Reaction to the proposed free trade deal has been mixed. Several observers have pointed out that such a deal would have been

unthinkable just a few years ago, but now note the support and enthusiasm for it. Some see it as a complement to the recent Canada-U.S. agreement, while being consistent with the traditional U.S. support for multilateral trade liberalization; in fact, some see it as a spur to greater progress by GATT. Nevertheless, there are also some strong and vocal opponents of the proposed deal, particularly unions and politicians in those states that would bear the greatest adjustment costs.

ISSUES FOR CANADA

At the end of August 1990, just before a federal Cabinet meeting, Ottawa announced that it would decide within two weeks whether it would be part of any Mexican-U.S. trade talks. On 6 September 1990, a financial journalist for the Globe and Mail wrote: "Canada has decided it wants to participate in trilateral trade talks with the United States and Mexico but has yet to work out acceptable rules for the negotiations with the other two countries." After the bitter controversy over the free trade agreement with the U.S., the government is aware of the potential political problems inherent in another set of trade negotiations.

The economic arguments for a Canada-Mexico-U.S. free trade deal are pretty much the same as those given above for a Mexico-U.S. deal (or those heard, perhaps ad nauseum, during consideration of the Canada-U.S. deal). They boil down to: gains from trade versus adjustment costs.

Supporters of a deal naturally emphasize the classic gains for consumers of lower prices and wider choice. These would tend to be widely distributed among citizens and spread over time. Producers would also have better access to a market of over 80 million people and thus gain additional opportunity to reap any benefits of economies of scale. Increased competition would also put pressure on firms (and their workers) to be more dynamic and flexible: to be inefficient would be to go out of business. But the drive for greater efficiency would lead to high adjustment costs.

It is the costs of adjustment that are emphasized by the opponents of free trade. These costs would tend to be bunched in the short

run; firms would quickly change product lines, close plants producing products that without protection were no longer competitive and open plants to make goods for which a comparative advantage had emerged. The costs of adjustment would also tend to fall on narrow groups; for example, the workers in plants that closed. While there would be long-run net economic gains to society from free trade, the average costs borne by some citizens might be far greater than the average gains to all citizens.

Opponents of free trade point to the wide disparity between the wage rates in Canada and Mexico as a sign that adjustment costs would be high. Advocates of the deal argue that Canada does not now have high barriers against Mexican products, yet we have not been swamped by these products. In fact, trade between Mexico and Canada is not very extensive. Mexico ranks as our 17th-largest trading partner; bilateral trade flows totalled about $2.3 billion in 1989.

Such relatively modest trade flows do not mean that all industries or firms in Canada would be unaffected by a trade deal with Mexico. Canadian banks and resource companies, for example, are quite concerned about possible liberalization of Mexican financial and energy sectors. Canadian telecommunications firms are developing niches in Mexico that could expand with further liberalization in that country. Agriculture is another sector that would be affected by a trade deal; Canada now exports about $150 million in agricultural and food products to Mexico and imports about $120 million from Mexico.

Of most concern to Canada are the possible effects of a deal on firms producing automobiles and automobile parts. This would remain a concern even if Canada does not join any U.S.-Mexico talks on trade liberalization. After all, with the Auto Pact, Canada-U.S. trade is dominated by the flows of autos and auto parts; in 1989 these flows totalled about $65 billion or about a third of total U.S.-Canada trade.

Obviously, a complete evaluation of freer trade between Canada and Mexico will necessitate detailed sectoral studies. Such studies would include autos and auto parts, agriculture, oil and gas, telecommunications, and certain low-wage industries such as textiles, footwear, ceramics and any industries with simple technology and straightforward assembly of products.

The studies will be complicated by the existing U.S.-Canada trade agreement and by any deal between the U.S. and Mexico. With "fourth" countries (that is, countries other than the U.S., Canada and Mexico) trading with and investing in the three countries, and with overlapping trade agreements, country-of-origin rules become an important determinant of trade patterns.

Although it is not possible to make precise estimates of the economic effects of freer trade between Canada and Mexico, it is possible to note the sectors that would be most affected and the possible direction and timing of any economic effects, the main issue in the proposed deal. To highlight the non-economic issues it is useful to examine some of the arguments that led to Canada's seeking a place at any trade negotiations involving the U.S. and Mexico.

One argument was that trade liberalization would aid development in Mexico, with concessions by Canada being on a par, and perhaps in the long run superior, to handouts from CIDA. Another argument, somewhat at odds with this, was that Canada's presence at the negotiation table might limit the concessions to Mexico, preventing that country from protecting some sectors under the guise of development, by erecting barriers to goods and services from Canada. If Canada did not take part, so these arguments ran, Mexico would get too little or too much -- at least from Canada's perspective.

Another argument was that Canada should join Mexico in North American trade talks to counter the economic and political power of the United States. Although Mexico and Canada will obviously not be on the same side for all issues, there will be times when their interests will coincide and together the two countries may gain concessions from the U.S. Note, however, that the combined population of Canada and Mexico is less than half that of the U.S., and the average GNP of the two, given Mexico's relative poverty, is well below that of the U.S. Whatever the mechanics of the trilateral negotiations, issues will not be decided on the basis of one country one vote. Still, there is scope for Mexico and Canada to work together for common interests.

As mentioned above, a North American free trade area would be about the same size and have about the same total GNP as a united Europe. Some observers see the globe becoming split into large trading blocs, so that a Canada-Mexico-U.S. bloc is needed to counter those in Europe and Asia. This concern has led to related concerns about the future of multilateral trade negotiations under GATT. Some argue that GATT began when high tariff barriers were the major impediment to international trade and when large firms produced at home and shipped the goods abroad; now that they ship their plants abroad to service local and regional markets, GATT has outlived its usefulness. GATT was successful in lowering tariffs and stimulating international trade, but it may no longer be capable of dealing with the changed world of economic relations. Some see U.S.-Mexican-Canadian trade negotiations as replacing GATT (though the U.S. and Canada pay lip-service to the primacy of multinational negotiations); others argue that bilateral or trilateral deals will prod GATT to become more flexible and useful. Either way, Canada should be part of the smaller negotiations.

The most frequent argument was probably that Canada should join the U.S.-Mexico trade talks in order to protect any gains from the Canada-U.S. Free Trade Agreement, among which was trade diversion from third countries; as these third countries, such as Mexico, negotiate separate trade agreements with the U.S. the trade diversion from them will be halted and -- even worse from Canada's view -- possibly reversed.

The overriding reason for Canada to join the talks is that the world is changing and Canada cannot prevent this by sitting on the sidelines. Instead, so this persuasive argument runs, Canada must go to the table and try to shape the changes now taking place.

MEXICO --- TRADE PROFILE

TABLE 1.
STATISTICS - (million $U.S.)

	OVERALL TRADE			TRADE WITH CANADA			TRADE WITH U.S.		
	EXPORTS	IMPORTS	BALANCE	EXPORTS	IMPORTS	BALANCE	EXPORTS	IMPORTS	BALANCE
1988	29,373	27,546	1,827	966	398	568	21,404	20,644	760
1987	26,972	19,950	7,022	886	398	488	18,654	14,583	4,071
1986	16,588	12,319	4,269	302	227	75	11,163	8,272	2,891
1985	22,105	13,441	8,664	393	235	158	13,341	8,954	4,387
1984	24,382	10,327	14,055	495	207	288	14,130	6,440	7,690

TABLE 2.
MEXICO's MAJOR TRADING PARTNERS
(1988 rankings with 1988 value in million $U.S.)

EXPORTS		IMPORTS	
1 UNITED STATES	21,404	1 UNITED STATES	20,644
2 JAPAN	1,446	2 JAPAN	1,772
3 SPAIN	1,005	3 GERMANY	963
4 CANADA	966	4 FRANCE	540
5 FRANCE	544	5 CANADA	398

TABLE 3.
MEXICO - CANADA TRADE
(million $U.S.)

MAJOR EXPORTS - 1989		MAJOR IMPORTS - 1989	
1 NUCLEAR REACTORS	466.2	1 VEHICLES	71.6
2 ELECTRICAL MACHINERY	335.1	2 IRON OR STEEL	71.3
3 VEHICLES	299.4	3 NUCLEAR REACTORS	63.5
4 PEARLS	199.5	4 OIL SEED	59.8
5 MINERAL FUELS	49.4	5 DAIRY PRODUCTS	46.4

Sources : IMF Yearbook 1989.
Statistics Canada, Cat. #65-003 and #65-006.

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